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No. 824

# In the Supreme Court of the United States

OCTOBER TERM, 1936

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

*v.*

J. J. PERKINS ET AL.

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## REPLY BRIEF FOR THE PETITIONER

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## REPLY BRIEF FOR THE PETITIONER

Certiorari was applied for and presumably granted solely to resolve a conflict with *Comar Oil Co.* v. *Burnet*, 64 F. (2d) 965 (C. C. A. 8th), certiorari denied, 290 U. S. 652, with respect to the question whether all of the proceeds from the sale of oil, including the portion paid to the prior owners of the leases, should be included in the operators' gross income. Our main brief is devoted to a discussion of that question. We contend that since the taxpayers were the operators as well as the owners of the oil leases which produced the income, they were chargeable with all of the income

produced by the business which they conducted. In addition, we contend that the payments which the taxpayers made to their assignors in consideration of the assignment of the leases were made for the transfer of property to which the taxpayers were taking title, and hence were not deductible as business expenses under the plain terms of the statute.[1].

Respondents do not deny that the amount sought to be taxed is income. Their position is that it is not their income but that of the assignors. Such a question depends upon the ownership of the property which produced the income, and it must be determined by resort to local law. In our main brief we have shown that under local law the taxpayers and not the assignors were the owners of the leases and of the oil in place. The terms of the assignment by which respondents acquired the leases are consistent with no other construction. The assignment recited that the assignors "do hereby bargain, sell, transfer, assign and convey all our rights, title, and interest in and to said leases and rights thereunder * * *." (R. 22.) Respondents, however, contend that they never acquired an interest in so much of the oil as will be necessary to satisfy the oil payments. We think that the Texas decisions cited fall far short of sustaining that contention.

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[1] Respondents were permitted to capitalize the oil payments as made. (R. 67.)

*Sheffield* v. *Hogg,* 124 Tex. 290, 77 S. W. (2d) 1021, upon which respondents chiefly rely, does not decide that the holder of a royalty interest is the owner of oil in place or part owner of the lease. It decides (p. 298) that the royalty holders have a fee simple interest in land, "or at least have a right belonging or appertaining to the horizontal strata of the land in which the minerals are embedded." The question there involved concerned a real estate tax, and while it may be sufficient for purposes of classification that the royalty owner has a right belonging or appertaining to the land, we submit that decision does not deny that the operating lessee owns the oil and the lease. The Texas courts still cite *Theisen* v. *Robison,* 117 Tex. 489, as authority for the proposition that a lessee acquires title to all of the oil and gas in place. *Group No. 1 Oil Corp.* v. *Sheppard,* 89 S. W. 1021, 1024. See, also, *Waggoner Estate* v. *Wichita County,* 273 U. S. 113; and *Shell Petroleum Corp.* v. *State,* 86 S. W. (2d) 245, 249. For purposes of an income tax there is no escape from the proposition that the income belongs to the owner of the business and the argument that, because of the lessor's interest, the proceeds from the sale of oil belong to him directly is quite inadmissible.

The situation in this case is a typical example of income assigned to pay an obligation. Cf. *Blair* v. *Commissioner,* No. 247, decided by this Court February 1, 1937. Respondents have assigned their in-

come to pay for the lease. Respondents constructively receive the income from extraction and sale of the oil and respondents' assignors receive purchase money which may or may not represent income. Respondents do not have a deduction for rent, because they have bought the lease.

The contention that respondents had no obligation because the assignment provided (R. 22) that the oil payment did not constitute a personal obligation is unsound. Because the assignors were willing to look exclusively to the oil payments for their money does not alter the fact that respondents' original obligation to pay for the lease was being satisfied by the oil payments. By the "contract of June 30, 1931" (R. 22), which is not in the record, respondents had some undisclosed obligation to give substance to the assignors' right to oil payments by drilling and development work.

The Texas decisions cited by respondents deal with the interest of the assignors, but they do not deny the interest and ownership of the operating lessees. Anyone who has contractual relations with a lessee under which he will receive money depending upon production, may be said to have an interest in production, but that is not a denial of the ownership of the lessee. For purposes of an occupation or production tax the State of Texas may tax the lessee upon all of the production or it may apportion the tax between the lessor and lessee. *Barwise* v. *Sheppard,* 299 U. S. 33. It may adopt

the latter course because they both have an interest in production. The imposition of an income tax, however, upon the owner of the income from oil property depends upon quite different principles. For purposes of an occupation tax the State of Texas may legislate upon the theory that lessor and lessee are engaged in a common venture for their mutual benefit, but Congress has not sought to make such "planned undertaking" or "mining venture" a taxable entity. Moreover, Congress could not, if it would, treat as income the entire amount of oil payments received by assignors. Assignors who have sold out their capital interest in the leases have a cost which must be deducted from the proceeds before there is any gross income. The oil payments do not constitute operating income of assignors. As to them it is not income from the extraction of oil. It is income from the sale of a capital asset, and taxable only to the extent that it exceeds their cost.

*Dunn* v. *Tennant,* 82 S. W. (2d) 728, shows the extremes to which the respondents' argument based upon Texas decisions would carry. It was there held that one who advanced $5,000 to a lessee as a loan and in consideration was to receive $25,000 of oil, had an interest in the land. Upon respondents' theory the oil necessary to pay the $25,000 did not belong to the lessee, and no Federal income tax could be imposed upon the lessee on account of its production. We submit that the Texas decisions

do not recognize an interest in the lessor to the exclusion of the lessee, and that they do not require that the lessee be relieved of the tax upon the income from its business. The theory has been adopted in this Court that the income is derived from the lease. *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393; *Gillespie* v. *Oklahoma*, 257 U. S. 501. Since no claim is made that anyone except respondents had an interest in the lease, it appears to be unimportant that others had some rights which the local law recognized as an interest in the land.

In view of the Texas decisions cited in the main brief for the petitioner, and the specific language of the assignment, there is no room whatever for the contention that respondents were not the owners of all the oil which they produced. Had they paid over the stated amount to the assignors after taking it into their own possession, the contention that the entire proceeds did not constitute their income would be quite inadmissible. However, the fact that for convenience and certainty the oil payments were made directly by the Pipe Line Company to the assignors does not change the situation.[2] The payment directly to the assignors was made with respondents' consent, and without their consent the Pipe Line Company would not have been authorized to make it.

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[2] The record shows similar direct payments to a bank (R. 47), but respondents concede the proceeds were for their account.

Respondents' brief is devoted principally to a discussion of what they contend to be conflicting rights to depletion, and they seek to have this case decided by the application of depletion principles. The court below adopted respondents' view, but we submit that the questions of income and of depletion are distinct and should not be confused. In *Poe* v. *Seaborn,* 282 U. S. 101, this Court has pointed out that liability to an income tax depends upon ownership of the income, and that ownership is determined by reference to local law. With respect to depletion, however, this Court held in *Palmer* v. *Bender,* 287 U. S. 551, that the taxpayer's right may depend merely upon whether he has a sufficient economic interest in the property, as to which the Federal Revenue Act is controlling. The fundamental fallacy in respondents' contention lies in the failure to appreciate that depletion is a statutory concept and that in that field Congress is free to ignore ownership and make allowances at pleasure. Accordingly, even if it appeared that through Congressional liberality depletion allowances were made to others, that should have no bearing upon whether respondents own the income from their business.

Respondents say the income cannot be theirs because if it is they are entitled to retain the depletion allowance already made, that their assignors will also be entitled to a depletion allowance under *Palmer* v. *Bender, supra,* and thus that

a result forbidden by *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, must necessarily follow. While, as has been stated, we do not believe that the decision of the question in the present case depends upon who is entitled to depletion,[3] in any event we submit that respondents' assignors are not entitled to a depletion allowance upon their oil payments.

Unlike this case, *Palmer* v. *Bender, supra,* did not involve an assignor who had transferred a lease for a stated sum of money. Under the leases there involved, Palmer's partnerships reserved a stated royalty which was to be paid as long as the oil properties continued to produce. Although it is difficult to see any connection between his economic interest in the *produced oil* and the depletion of the *oil in place* (Cf. *Theisen* v. *Robison,* 117 Tex. 489, 510–511), this Court held that Palmer belonged to the class which Congress intended to benefit by the depletion allowance. It would seem that instead of suffering from the extraction of oil, Palmer was actually benefitted by production. His economic interest being exclusively in produced oil, it required production to give any value to his interest. Non-production made his economic interest valueless. Production did not deplete any cap-

[3] It is not without significance that the denial of certiorari in *Comar Oil Co.* v. *Burnet,* 290 U. S. 652, occurred after the decision in *Palmer* v. *Bender,* 287 U. S. 551.

ital interest of his. Because he was allowed depletion, however, it has been assumed by some other courts, erroneously as we think, that all assignors are similarly entitled to depletion. We earnestly submit that the decision in *Palmer* v. *Bender* should not be so extended.

Unlike the assignor there involved, the respondents' assignors have bargained for a stated sum of money, after the receipt of which they will have absolutely no interest in the production from this property. Their interest, we submit, is clearly not of a character which suffers from the operation of the property. The assignors here have limited themselves by a maximum figure which precludes the contention that each barrel taken out *pro tanto* reduces their capital interest.

Their situation is analogous to that of the stockholder who receives a dividend. While it reduces the intrinsic capital value of the shares by an equal amount, the dividend is nevertheless all income. *United States* v. *Phellis,* 257 U. S. 156, 171. The barrel of oil necessary to make the last oil payment clearly does not reduce any remaining interest of the assignors. It is only in a theoretical sense that it can be said that any barrel taken out reduces the possibility that enough remains to make all of the oil payments. That is clearly not true of the first barrel, for it establishes the existence of additional barrels. The same theoretical reduction of intrinsic value is involved in the receipt of dividends

by a stockholder, and in *Lynch* v. *Hornby*, 247 U. S. 339, 346, this Court gave it no effect, saying:

> We do not overlook the fact that every dividend distribution diminishes by just so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock. But, at the same time, it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares. In our opinion, Congress laid hold of dividends paid in the ordinary course as *de facto* income of the stockholder, without regard to the ultimate effect upon the corporation resulting from their payment.

Moreover, it must be remembered that the assignors' cost is returned to them tax-free in the computation of gross income,[4] and they are taxed only on the portion of the selling price which exceeds cost. Therefore, any reduction of the oil reservoir by extraction involves merely a loss of anticipated profits rather than an actual loss of capital.

The assignors have exchanged their interest in the oil in the ground for an interest in produced oil and have further limited themselves to an interest which is not to endure for the life of the property. Instead of having an interest in the operation of the wells as long as they produce, the assignors now have a definitely fixed maximum interest which is

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[4] See, *infra*, p. 13.

opposed to conservation and economical operation in the interest of prolonging the life of the property. Their interests are best served now by production, and by prompt and full production. The faster the oil is taken out the quicker will the assignors get their money. Since their interest is in produced oil only, production enhances the value of their interest rather than depletes it.

It is not true here, as this Court said it was in *Palmer* v. *Bender, supra,* p. 558, that "The loss or destruction of the oil *at any time from the date of the leases until complete extraction* would have resulted in loss to the partnerships." [Italics supplied.] While this Court there made no distinction between an actual loss and a mere loss of anticipated profits, it is clear that in this case the suggested destruction would not affect respondents' assignors unless it occurred before the final payment to them, for their connection with the property was limited as to time.

*Palmer* v. *Bender, supra,* is further distinguishable in that Palmer's partnerships made the discovery of oil. With respect to that matter this Court said (pp. 557–558):

> The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original cost. The benefit of it accrues to the discoverer if he operates the well as owner or lessee, or if he leases it to

> another. It would be an anomaly if that policy were to be defeated and all benefit of the depletion allowance withheld because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another.

Clearly, that was a consideration which led to the allowance of depletion in *Palmer* v. *Bender*, and it does not apply in this case. The respondents and not their assignors were responsible for the development of the property here involved. The property was not producing at the time respondents and their associates acquired it. (R. 21.) Respondents developed the property, drilled the wells and discovered the oil. (R. 31.) In so far as the depletion allowance is considered as representing a legislative policy favoring the discoverer of oil, it is an argument for making the depletion allowance to respondents alone and not requiring them to share it with the assignors, who have had a merely casual connection with the property as prior owners of the lease.

While *Palmer* v. *Bender* is distinguishable because Palmer discovered the oil and respondents' assignors did not, we would not be understood as conceding that Congress intended to make a depletion allowance to those assignors who did discover oil. Special provision was made elsewhere for their industry and perseverance.

It is clear that respondents' assignors sold an interest in oil and gas wells within the meaning of Section 102 of the Revenue Act of 1932, and if the principal value of the property had been demonstrated by prospecting or exploration and discovery work done by them, they would have been entitled to the preferential rate of tax provided for by that section. A taxpayer claiming the benefit of a deduction must show that he is clearly within the class which Congress intended to benefit. Assignors are clearly provided for in Section 102 and they are not specifically provided for in the depletion provision (Section 23 (l)). Before they are given the benefit of both sections it should be made to appear that there is some basis for such Congressional generosity and solicitude.

Moreover, the respondents' assignors do not account for all of the oil payments as income but only the amount by which the oil payments exceed the assignors' cost. They sold their oil lease and whatever it cost them must be taken out of the proceeds before they have any gross income. *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179. Since their cost is taken out before there is any gross income, it appears entirely illogical to permit them to reduce the gross income by a depletion allowance. The theory of depletion is that it is a means of returning the taxpayer's cost, but in the case of assignors the cost has already been returned in the computation of gross income. To permit a de-

pletion allowance in such circumstances is clearly to make a double deduction, for which there is no Congressional sanction.

This record does not show what investment respondents' assignors had made in the property. Therefore, it cannot be said with any assurance that the oil payments represent gross income to them, either in whole or in part. If they have no income from the property they are not entitled to depletion under any circumstances. Accordingly, it appears that respondents' argument with respect to conflicting depletion allowances rests upon pure speculation.

In *Commissioner* v. *Fleming,* 82 F. (2d) 324, the court below made a distinction between the "oil payments" and cash payments, permitting a depletion deduction for the former, but denying it for the latter. If payment out of production is to be the test, the field of favored taxpayers entitled to depletion is limitless. Turnkey contractors commonly receive oil payments as compensation for drilling wells (Cf. *Edwards Drilling Co.* v. *Commissioner,* 35 B. T. A. 341), but it has not been supposed that the form of their payment gives them any claim to a depletion deduction. We submit that oil payments do not indicate a depletable interest, but that the right to depletion allowance depends upon an interest in the lease or the oil in place.

For these reasons, we submit that *Palmer* v. *Bender, supra,* does not require that a depletion

allowance be made to respondents' assignors, and that this Court may properly decide the question of income here involved on its own merits without confusing that issue with depletion.

### CONCLUSION

For the foregoing reasons, it is respectfully submitted that the decision of the court below should be reversed.

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MAY 1937.

# APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating

the trust, or, in the absence of such provisions, on the basis of the trust income allowable to each. (For percentage depletion, see section 114 (b) (3 and (4).)

* * * * *

SEC. 102. SALE OF MINES AND OIL OR GAS WELLS.

(a) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by section 12 of this title attributable to such sale shall not exceed 16 per centum of the selling price of such property or interest.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.—

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

* * * * *

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